U.S. Customs Service
Office of Strategic Trade
Regulatory Audit Division

Consideration of Internal Control in a Customs Compliance Audit

Consideration of Internal Control in a Customs Compliance Audit

Table of Contents

U.S. Customs Service
Office of Strategic Trade
Regulatory Audit Division

Consideration of Internal Control in a Customs Compliance Audit

Introduction

This document provides direction for the Customs team in evaluating a company's internal control during an audit of a company's compliance with Customs requirements. It defines internal control, describes the objectives and components of internal control, and explains how the Customs team should consider internal control in planning and performing an audit. In particular, it provides guidance for implementing United States General Accounting Office (GAO) *Government Auditing Standards*[1] (the Yellow Book) relating to internal controls for audits of Customs requirements.

The Yellow Book, paragraph 2.4 b., states that financial audits include financial statements and financial related audits.

> Financial related audits include determining whether (1) financial information is presented in accordance with established or stated criteria, (2) the entity has adhered to specific financial compliance requirements, or (3) the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives.

The Yellow Book, paragraph 2.5, states that financial related audits may include audits for compliance with laws and regulations.

The Yellow Book, paragraph 4.21, includes the following field work standard for financial audits:

> Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed.

In the Yellow Book, paragraph 6.39, GAO fieldwork standards for performance audits require auditors to obtain an understanding of management controls. The GAO publication *Assessing Internal Controls in Performance Audits* [2] (the Gray Book) provides extensive guidance for assessing internal controls.

Customs compliance audits are different from traditional financial audits because Customs audits are not audits of financial statements. The primary objective of Customs compliance audits is to determine compliance, including correct reporting to Customs. Reporting to Customs includes numerous financial issues. In addition, some elements of Customs compliance audits, such as correct reporting of classification, country of origin, and other specific information of concern to Customs, are more closely related to performance audits than financial audits.

Since Customs compliance audits include aspects of financial audits and performance audits, this document combines appropriate internal control aspects applicable to financial and performance audits. Internal control aspects that would not be relevant to Customs compliance audits, such as control of assets, are not included. Because GAO and American Institute of Certified Public Accountants (AICPA) standards for financial audits are not oriented to Customs regulatory compliance, this document combines applicable information from GAO standards for financial and performance audits to develop procedures for evaluating compliance with Customs requirements. Information from AICPA Statement on Auditing Standards (SAS) No. 78 *Consideration of Internal Control in a Financial Statement Audit* [3] is included for guidance when appropriate.

In Customs compliance audits, the Customs team should obtain sufficient understanding of internal control to plan the audit by performing procedures to understand the design of controls and whether they have been placed in operation and are effective.

Definition of Internal Control

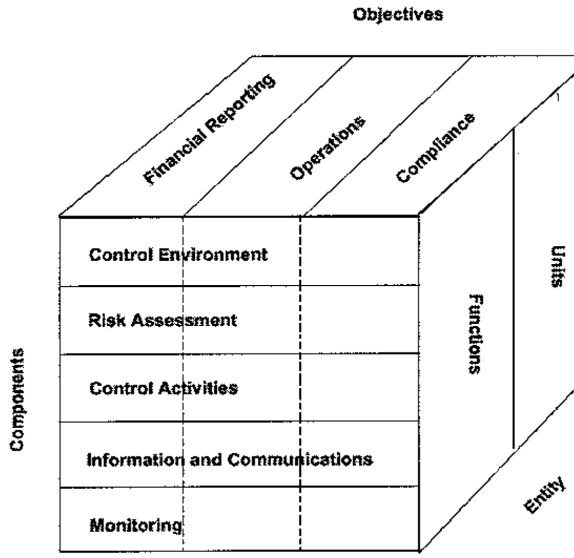
AICPA SAS 78 (paragraphs 6–7) states the following regarding internal controls:

> Internal control is a process—effected by an entity's board of directors management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.
>
> Internal control consists of the following five interrelated components.
>
> a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
> b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
> c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.
> d. *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
> e. *Monitoring* is a process that assesses the quality of internal control performance over time.

Relationship Between Objectives and Components

The relationship between objectives and components of internal controls is explained in AICPA SAS No. 78 as summarized below.

There is a direct relationship between objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. In addition, internal control is relevant to the entire entity or to any of its operating units or business functions. These relationships are depicted in the following figure.



Generally, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes. Controls relating to operations and compliance are particularly relevant to Customs compliance audits because they pertain to the Customs team's evaluation of the risk to Customs that the company's importing process may result in significant noncompliance with laws and regulations.

The five components of internal control are applicable to assessments of compliance with Customs requirements. The components should be considered in the context of the following:

- The entity's size.
- The entity's organization and ownership characteristics.
- The nature of the entity's business.
- The diversity and complexity of the entity's operations.
- The entity's methods of transmitting, processing, maintaining, and accessing information.
- Applicable legal and regulatory requirements.

Benefits of Internal Control Assessments

The Gray Book (page 12) states the following:

> Internal control assessments can help auditors perform assignments more quickly and work with greater assurance that objectives are achieved. Such assessments help to:

- Determine when internal controls can be relied on to reduce audit testing,
- Focus on areas of weakness for emphasis during the assignment, and
- Identify potential causes of problems or deficiencies to which recommendations for corrective action can be directed.

Internal controls, no matter how well designed and implemented, can provide only reasonable assurance regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control, such as human judgment in decision making and human errors or mistakes. In addition, the cost of internal controls should not exceed the expected benefits. Usually, precise measurement of costs and benefits is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating cost-benefit relationships.

The steps taken to assess controls may simultaneously help attain other objectives, such as resolving the overall assessment objective or assessing compliance with applicable laws and regulations.

The audit objective determines the extensiveness of internal control assessment as well as the scope and methodology of the audit. Assignments with broad objectives are generally more difficult and require more resources and time than assignments with limited objectives. Therefore, objectives should be defined as precisely as possible to preclude unnecessary work while meeting the assignment's purpose.

Assessing Risk

The following guidance should be used for assessing risk:

- If the Customs team concludes that transaction testing can be limited because the company has an acceptable level of internal controls, the Customs team must document the controls and tests of those controls made to assure their operation and effectiveness.
- The Customs team can use a combination of different types of tests to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that internal controls are adequate and effective.
- Observation provides evidence about a control's effectiveness only at the time observed; it does not provide evidence about its effectiveness during the rest of the period under audit.
- The Customs team can use evidence from tests of controls done in prior audits, but it has to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since it last performed those tests.

Evaluating Internal Controls

The first step in evaluating internal controls is to determine the risk exposure, which is the likelihood of significant noncompliance with laws and regulations. The next step in the process is to review the system of internal control. The relationship of risk exposure to the system of internal control determines the nature and extent of audit tests. The audit tests provide an evaluation of the effectiveness of internal controls. The combined results from the risk exposure, review of the design of the internal control system, and tests of internal controls are the basis for an opinion on the adequacy of internal controls. The extensiveness of tests of internal controls is illustrated below:

Determine Extensiveness of Audit Tests

Risk Exposure	+	Preliminary Review Internal Control	=	Extensiveness of Audit Test
High		Weak		High
		Adequate		Moderate to High
		Strong		Low to Moderate
Moderate		Weak		Moderate to High
		Adequate		Moderate
		Strong		Low
Low		Weak		Low to Moderate
		Adequate		Low
		Strong		Very Low

Source: Table adapted from the GAO Gray Book.

AICPA SAS 78 (paragraphs 19–21) provides the following internal control guidance:

> In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation. In planning the audit, such knowledge should be used to—
>
> - Identify types of potential misstatements.
> - Consider factors that affect the risk of material misstatement.
> - Design substantive tests.
>
> The nature, timing, and extent of procedures the auditor chooses to perform to obtain the understanding will vary depending on the size and complexity of the entity, previous experience with the entity, the nature of the specific controls involved, and the nature of the entity's documentation of specific controls. For example, the understanding of risk assessment needed to plan an audit for an entity operating in a relatively stable environment may be limited. Also, the understanding of monitoring needed to plan an audit for a small, noncomplex entity may be limited.
>
> Whether a control has been placed in operation is different from its operating effectiveness. In obtaining knowledge about whether controls have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the control was applied, the consistency with which it was applied, and by whom it was applied. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of internal control.

Although SAS 78 does not require the auditor to obtain knowledge about operating effectiveness as part of understanding of internal control, knowledge about operating effectiveness is necessary to determine the reliability of internal controls, decide the extent of audit testing, and assess risk. Therefore, Customs assessments of internal controls will include evaluations of the effectiveness of internal controls.

Assessing Risk Exposure

The key considerations of risk exposure for audits of Customs compliance are:

- Significance and Sensitivity
- Susceptibility
- The Existence of "Red Flags"
- Management Support
- Competent Personnel

Significance and Sensitivity

The Gray Book (pages 16–17) defines significance and sensitivity as follows:

Significance refers to the importance of items, events, information, matters, or problems. Frequently significance can be assessed in terms of dollars. In other instances, assessing significance requires a more subjective judgment. For example, the unauthorized use of a government vehicle in a single instance is normally considered of limited significance, but unsafe operation of a nuclear power plant is of great significance since a failure could be a catastrophe.

Sensitivity refers to the likely perception and emotional response by others to conditions or circumstances. Determining sensitivity requires judgment based on the circumstances in each case, but some issues likely to be judged as sensitive include:

- issues that have received media coverage;
- issues that have been the subject of congressional interest and inquiry;
- issues of a highly partisan nature;
- issues involving mistreatment of children or the elderly; and
- issues involving environmental contamination or pollution.

A high degree of risk exposure may be indicated by either the significance or the sensitivity of the subject matter under review, or matters may be both significant and sensitive.

Issues likely to be judged significant and sensitive by Customs include the issues listed above as well as issues of antidumping/countervailing duty, transshipments, Intellectual Property Rights, health and safety, and others.

Susceptibility

Susceptibility refers to the propensity for noncompliance with laws and regulations. An issue of large significance does not necessarily involve great susceptibility. For example, the risk of misclassification of large quantities of imports may have a high significance because the total duty involved may be high. But these imports may not have a high susceptibility to misclassification if a limited number of Harmonized Trade Schedule of the United States (HTSUS) numbers are involved and the classification issues are not complex.

The Customs team should formulate questions to assess susceptibility based on the inherent nature of the import. Examples of questions to ask follow:

- Is the imported item, manufacturer, country of origin, or other element designated as high risk by Customs?
- Does Customs have information that indicates internal control weaknesses pertaining to the importer?
- Do incentives to make false representations/declarations outweigh the penalties?
- Are requirements imposed reasonable, or are they so complicated and cumbersome that failure to comply can be expected?
- Does the activity have numerous transactions or diverse activities?
- Does the importer contract out activities without adequate control systems?

The Existence of any "Red Flags"

The Customs team should be alert to and consider any red flags, including:

- A prior history of Customs problems;
- A history of material weaknesses described in prior Customs audits;

- Poorly defined and documented internal control procedures;
- Lack of or ineffective monitoring of Customs operations;
- Complex Customs transactions;
- Lack of specific performance measures for Customs operations, thereby making accountability for results difficult or impossible to measure;
- Management inability to correctly establish priorities;
- A high rate of personnel turnover in key occupations related to Customs activities;
- Inadequate Customs training for personnel responsible for reporting, monitoring or otherwise involved in Customs activities;
- Poor communication systems regarding Customs requirements and reporting; and
- Poor oversight of Customs brokers and other agents involved in Customs activities.

Management Support

The Customs team should consider whether management recognizes the importance of, and has made a commitment to implement, internal controls of Customs operations. Examples of questions to ask follow:

- Has management set the right tone by clearly stating, in writing, its expectations for compliance with Customs requirements?
- Is there a strong and competent organization within the company to assure Customs compliance?
- Does the Import Department have sufficient authority within the organization to assure Customs compliance?
- Does management require periodic reviews of Customs operations?
- Does management promptly respond when Customs problems are identified, or have problems been repeatedly disclosed in prior audits/evaluations?
- Is management knowledgeable about Customs and potential Customs issues?
- Is management willing to discuss various aspects of Customs operations cooperatively?

AICPA SAS 78 (paragraph 25) discusses this concept as the control environment that sets the tone of an organization, influencing the control consciousness of its people. The control environment is the foundation of all other components of internal control, providing discipline and structure.

Competent Personnel

Managers and employees responsible for Customs operations should maintain a level of competence that allows them to accomplish their duties as well as understand the importance of developing and implementing good internal controls. Examples of questions to ask follow:

- Is there a stable management team with continuity?
- Are employees periodically reminded of their responsibilities?
- Are employees provided with needed formal and on-the-job training?

Assessing the Effectiveness of the Internal Control System

After assessing risk exposure, the Customs team should review the internal control system and then test internal controls to assess the effectiveness of the internal control system. In most cases, internal control assessments are necessary to ensure that audit work will meet assignment objectives. Any transaction examined might be atypical. Control assessments give evidence whether transactions are likely to be handled in the same manner. Internal controls for Customs compliance should be designed to include the five components of internal control: (1)

control environment, (2) risk assessment, (3) control activities, (4) information and communications, and (5) monitoring.

The Gray Book lists the following key steps in assessing internal controls:

- Identify and understand relevant internal control(s);
- Determine what is already known about control effectiveness;
- Assess adequacy of control design;
- Determine if controls are properly implemented; and
- Determine if transactions are properly documented.

Internal control testing is particularly important in the last three steps for assessing internal controls.

The objective of determining the effectiveness of internal controls is to determine the extent to which they can be relied on and thereby reduce the extent of audit testing. The greater the reliance that can be placed on internal controls, the less testing may be required.

Identifying Controls

The auditor must identify the controls that are needed to assure Customs compliance. An effective internal control system consists of five components. Internal control of Customs activities should be designed to include controls for the five components. The following information can be used to identify the controls necessary to assess the components of a Customs control system:

- The control environment sets the tone of the organization. Management and employees should have a positive and supportive attitude toward Customs internal control and conscientious management of Customs-related operations. Management should support the development and maintenance of effective internal control. The control environment includes a message of integrity and ethical values, commitment to competence of personnel, an organizational structure that contributes to effective internal control for Customs operations, and a philosophy and operating style that supports the development and maintenance of effective internal control.
- Risk assessment is an evaluation of risk pertaining to Customs activities. Management should establish clear and consistent company-wide objectives and support activity-level objectives related to Customs activities. Management should make a thorough identification of risks from both internal and external sources. Management should analyze those risks and develop an appropriate approach to manage risk. Mechanisms should be in place to identify changes that may affect the company's ability to achieve its missions, goals, and objectives related to Customs activities.
- Control activities are policies, procedures, techniques, and control mechanisms to ensure adherence to established Customs requirements. Proper control activities should be developed for each of the company's Customs activities. A system for Customs compliance includes the methods and records used to identify, assemble, analyze, classify, record, and accurately report Customs information and maintain accountability for Customs compliance.
- Information and communication systems must be in place to identify and record pertinent operational and financial information relevant to Customs activities. A system must be in place to communicate information to management responsible for Customs activities and others within the company who need it, in a form that enables them to carry out their duties and responsibilities efficiently and effectively. Such a system also assures that effective external communications occur with groups that can affect the achievement of the company's missions, goals, and objectives related to Customs.

- Monitoring assesses the quality of performance related to Customs activities over time. Management should have procedures in place to monitor internal control continuously as a part of the process of carrying out its regular activities. In addition, separate evaluations of internal control should be performed periodically and deficiencies investigated. Findings of all audits and other reviews should be evaluated, decisions made about the appropriate response, and actions taken to correct or otherwise resolve the issues.

Internal control component guidance is modified from the GAO Exposure Draft *Internal Control Management and Evaluation Tool*.[4]

Known Control Effectiveness

The Customs team should consider what, if anything, is known about control effectiveness. If Customs or another organization made an internal control assessment, the Customs team should consider how recent and thorough the assessment was, as well as the organization's reputation, qualifications, and independence. A determination can then be made whether to rely on the results or do additional tests. If prior control assessments are considered to be sufficiently recent and thorough, the Customs team need not further assess internal control design and effectiveness.

Assessing Control Design

Considering the information developed during the assessment of risk exposure, the Customs team should decide what is most likely to be wrong (e.g., valuation, classification, special trade programs). Then the internal controls should be examined to determine whether they are logical, reasonably complete, and likely to deter or detect possible failures or errors that will result in noncompliance. Generally, the greater the risk exposure, the stronger the internal controls should be.

Controls should provide reasonable but not absolute assurance of deterring or detecting noncompliance. In assessing the extensiveness of needed controls, the Customs team should consider the reasonableness of the controls in relation to the benefits to be gained.

Assessing Control Implementation

The Gray Book (pages 26–27) provides the following guidance pertaining to the implementation of internal controls:

> Even though internal controls may be logical and well-designed and may seemingly be strong, system effectiveness may be impaired if control procedures are not correctly and consistently used. . . .Thus, the extent that control procedures are adhered to should be determined.
>
> Control procedures may not be complied with because management may override them; employees may secretly be working together (collusion) to avoid using or circumvent them; and employees may not be correctly applying them due to fatigue, boredom, inattention, lack of knowledge, or misunderstanding.
>
> Sufficient testing should be conducted to afford a reasonable basis for determining whether the controls are being consistently applied.

Proper Transaction Documentation

Transactions and events pertaining to Customs compliance should be clearly documented, and documentation should be readily available for examinations. Examples of questions to ask follow:

- Are internal control objectives and procedures formalized in writing?
- Are all transactions and events adequately documented, and is documentation readily available for examination?
- Does documentation show personnel involved in monitoring, evaluation methods used, key factors considered, tests performed, and conclusions reached?
- Does documentation show corrective actions taken for problems identified during monitoring processes?
- Are follow-ups to verify adequacy of corrective actions documented?

In summary, when evaluating internal control, Customs audits must consider the five components of internal control, five factors for determining risk exposure, and five factors for assessing the design and effectiveness of the internal control system. This internal control approach is summarized in the 5-5-5 Guidance in Appendix I.

Determining Reliability of Computer-Processed Data

Generally accepted government auditing standards in the Yellow Book (paragraph 6.62) require that computer-processed data be valid and reliable when those data are significant to the auditors' findings. This is generally done through tests such as macro tests, comparison of company data to Customs data, and verifications of computer data to audited financial statements when possible.

Reporting on Internal Control Assessments

The Yellow Book sets specific standards for reporting on internal controls. These standards will be applied in Customs audits.

[1] United States General Accounting Office, *Government Auditing Standards*, 1999 revision.

[2] United States General Accounting Office, Office of Policy, *Assessing Internal Controls in Performance Audits,* GAO/OP-4.1.4, September 1990.

[3] American Institute of Certified Public Accountants, Statement on Accounting Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit,* December 1995.

[4] United States General Accounting Office, *Internal Control Management and Evaluation Tool EXPOSURE DRAFT*, GAO-01-131G, February 2001.

Appendix I

Internal Control
5-5-5 Guidance

5 Interrelated Components of Effective Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

How to Assess Internal Control

5 Considerations for Risk Exposure, Determine:

- Significance and Sensitivity
- Susceptibility
- Red Flags
- Management Support
- Competent Personnel

5 Considerations to Assess Control Effectiveness:

- Identify and Understand Control
- What is Known about Control Effectiveness?
- Examine Control Design
- Are Controls Implemented?
- Are Transactions Documented?